

The Difference Between Gold And Debt

GE Christenson



The world has added approximately \$60 Trillion in debt since 2007, much of it sovereign debt created from deficit spending on social programs, wars, and much more. In that time the world has mined perhaps 30,000 tons of gold, or about 950 million ounces, worth at September 2015 prices a little more than a Trillion. It is easy to create debt — central banks “print” currencies by **BORROWING** those currencies into existence. Debt increases, currency in circulation increases, and until it crashes, life is good for the financial and political elite. But debt increasing 60 times more rapidly than gold indicates that debt is growing too rapidly and due for a reset.

It is a tangled web of debt, counter-party risk, obligations, and unintended consequences. From an **interview with David Stockman**:

Stockman goes on to paint a grim picture and says, “What happens when the financial breakdown comes is there is a great margin call. Everybody says ‘I want my money back and I’ll take your collateral if I don’t get it back. If I do take your collateral, I will sell it for whatever price I can get and cut my losses.’ So, this is truly a house of cards. The whole pyramid of debt and what we call hypothecation and re-hypothecation of financial assets, that is the real bubble. That’s what people don’t focus on enough. Sure, you can think of stocks that are a bubble, like Tesla and its current price of around \$250, or the biotech index which is trading at hundreds of times earnings is crazy. What’s really crazy is all of this debt that has been created has been turned into collateral and borrowed against at a very high rate. The whole thing is very unstable and tottering as we speak.... Much of this collateralized credit that has been created is a confidence game. It is a daisy chain, and when the confidence breaks and they start to unwind the chain, the amount of debt outstanding will shrink. That will create tremendous broken furniture in the financial system.”

How do you protect yourself? Stockman says, “The place to go in my view is cash. Stay short and liquid because we are going into deflationary collapse. We are going into a great reset in the financial markets where inflated asset values are going to be marked down tremendously, bond prices and stock prices. As a result of, that there will be great opportunity after the dislocation runs its course to buy things much cheaper than they are priced today.”

Continued on page 3

Failure To Launch

Peter Schiff

The popular belief that the US economy has been steadily recovering has endured months of disappointing data without losing much of its appeal. A deep bench of excuses, ranging from the weather to the Chinese economy, has been called on to justify why the economy hasn't built up any noticeable steam, and why the Fed has failed to move rates off zero, where they have been for seven years. But the downright dismal September jobs report that was released last Friday may prove to be the flashing red beacon that even the most skilled apologists can't explain away.

The report should make it abundantly clear that we are far closer to recession than recovery. But old notions die hard and, shockingly, most economists still believe that we have hit a temporary speed bump not a brick wall. But at some point healthy hope turns into dangerous delusion.

Continued on page 2

Also Inside This Issue:

- **One By One The Central Banks Are Losing Control**
By: Graham Summers
- **Meet QT; QE's Evil Twin**
By: Peter Schiff
- **All Bad At 0%?**
By: Axel Merk

One By One The Central Banks Are Losing Control

Graham Summers

Since 2008 the Keynesians running global Central Banks had always suggested that there was no problem too great for them to handle. They'd promised to do "whatever it takes" to maintain the financial system and print the world back to growth.

Thus far, we'd seen some pretty aggressive moves. The most aggressive was committed by the Bank of Japan, which announced a single QE program equal to 24% of Japanese GDP in April 2013.

However, the SNB (Swiss National Bank) was the first Central Bank to actually reach the point at which it had to decide between printing a truly insane amount of money relative to GDP (50%+) or simply giving up. It chose to give up.

In many ways, the SNB was cornered by the ECB into this situation. I think this is why the SNB decided to make its announcement on a Thursday as opposed to over the weekend (when Central Banks usually announce bad news to minimize the market impact). The SNB *wanted* to cause mayhem, likely because it was frustrated by the ECB's upcoming QE program of which the SNB was undoubtedly aware in advance.

This situation has since progressed with an even larger, more important Central Bank buckling to market forces.

That Central Bank is China.

As we've noted before, China's economy is in tatters. At best it is growing around 3.5%. At worst it isn't growing at all. And with its currency closely linked with the US Dollar (which is in a bull market) Chinese exporters were getting destroyed. So what did China do? It chose to devalue the Yuan.

Continued on page 4

Failure To Launch

Continued from page 1

We may have just turned that corner.

The report was horrific any way you slice it. The consensus of economists had expected to see 203,000 new jobs in September, not a particularly impressive number, but at least it would have been an improvement from the 173,000 new jobs that were added in August.

Not only did September miss substantially, at just 142,000 jobs, but August was revised down to 136,000 (Bureau of Labor Statistics). There were economists who had even expected August to be revised up to as high as 247,000. This means that the last three months have averaged just 167,000 jobs, a level that is not even close to where we should have been in a real recovery. But it gets worse from there.

The labor force participation rate got even lower still, dropping from 62.6% of working age adults, to just 62.4%, a near-40 year low. In September, another 579,000 potential workers gave up looking for jobs altogether and simply left the labor force. This figure dwarfs the 142,000 people that actually found jobs. Those lucky enough to still be working saw no increase in their hourly wages (the consensus had expected a .2% increase) and their average workweek ticked down from 34.6 hours to 34.5. In short, in September, fewer Americans worked, and those who did had fewer hours and lower pay. This is not supposed to be what a recovery looks like.

Even after the Fed surprised markets back in September by failing to raise interest rates for the first time in nine years, most economists still strongly believed that the Fed was on track to do so this year. Just prior to Friday's jobs report, a full 94% of economists in a Reuters survey saw a hike coming this year. No word yet on how much these expectations may have changed since Friday's jobs report, but my guess is that they won't fall nearly as much as they should. Many a happy economist took to the airwaves last week to explain that two more jobs reports will be issued before the Fed's December meeting. They insisted that those reports could provide the impetus that the Fed needs to finally pull the trigger.

But Janet Yellen said months ago that she would need to see "further improvements" in the labor market before she felt fully comfortable in raising rates. Since she made that statement, not only has the labor market not improved, it has actually regressed considerably. The fact that the headline unemployment rate has remained at a very low 5.1% is immaterial, as that rate has been low for some time without prompting any rate hikes. Yellen has already conceded that the official unemployment rate is not the benchmark she is using to assess the strength of the labor market. Instead, she is focused on labor force participation, wages, and the proliferation of involuntary part-time work. On these scores we continue to move further away from any potential rate hike.

But rather than questioning the Fed's credibility in missing another forecast, most economists are lauding it for supposedly seeing weakness that others missed, which allowed it to wisely do nothing in September. But I see this simply as a continuation of the Fed's long-standing playbook: Talk the economy up through optimistic statements while continually holding off an actual rate hike that the Fed is concerned could undermine an economy teetering on the brink of recession. I did not expect the Fed to raise rates in September, and I don't expect them to do so in December either, or at all in 2016, for that matter. I expect the Fed shares this view but they know any public utterance could be disastrous. Despite the fact that I was one of the few economists to declare no hikes in 2015, the media has continued to ignore and ridicule my forecasts.

Dazzled by the Fed's many statements of gaining economic strength, Wall Street has, by contrast, been completely blind to the many, many signs of gathering weakness. In September, factory orders were down year-over-year for the 10th month in a row, according to the Census Bureau's August Factory Orders report.

As far as I know, this has never happened outside of a recession. But good luck finding anyone on Wall Street who shares my opinion that these figures suggest that a recession is already underway. My position is buttressed by the steady torrent of disappointing production numbers contained in the regional Fed surveys. But since manufacturing is no longer considered an important sector for the American economy, those once important surveys are no longer even mentioned in mainstream press.

Continued on page 4

The Difference Between Gold And Debt

Continued from page 1

Stockman thinks the whole system unwinds sometime before the 2016 Presidential race is finished. (emphasis mine)

Critical Points Regarding Debt:

- Margin calls come when markets crash, like now.
- Then we discover who has been “swimming naked” as Warren Buffet says.
- The daisy chain of hypothecated and rehypothecated dodgy assets backing massive loans **breaks**. Counter-party risk can overwhelm the financial system.
- The towering edifice of debt is unstable and survives primarily due to confidence, until confidence crashes as it did seven years ago.
- A collapse in confidence occurs along with a collapse in prices for bonds and stocks. Given that trillions in bonds have been inflated to the point of negative and near zero yields, there is downside room for a substantial correction in the 35 year bond bull market.
- When companies float 100 year bonds the bond bubble is nearing its inevitable and ugly end.
- Stocks in the US have corrected or crashed approximately every seven years. The S&P 500 Index hit an all-time high in May of 2015, seven years since its last major high prior to a crash. There is considerable downside ahead, perhaps even if the FED cranks up QE4 and QE5 to levitate the stock market.
- Question: If the Fed is the “buyer of last resort” who does the Fed sell to? The problem with the uncharted monetary territory that the Fed has led the world into is that unpleasant and unintended consequences lie ahead.

From Adrian Ash (Bullion Vault):

“But if the Fed is scared, investors and savers should be doubly so. Central bankers have led us deep into a forest where money does grow on trees, but not [economic] growth or stability, and now they can’t find the way out.”

“When night falls, there’s a very clear risk of panic as investors realize that central bankers, like the markets, are lost in the dark.”

Critical Points Regarding Gold:

- No counter-party risk. There is no daisy chain of hypothecated assets for real physical gold. If you own paper gold, think again about counter-party risk. If you think you own gold but your friendly neighborhood banker has sold, loaned, or leased your gold multiple times, there will be a problem when you wish to withdraw that gold from the labyrinth of that bank. Worse, the banker may have stolen that gold and left an IOU gold in the vault. Of course, some people trust their bankers and are not concerned ... fines, indictments, and prosecutions notwithstanding.
- Fort Knox contained 147 million ounces of gold as of the last count ... many decades ago. Since the last audit was performed 60 some years ago, there is risk that the Fort Knox Bullion Depository is actually the Fort Knox Delusion. Apparently “trust but verify” is no longer viable, so act accordingly. Confidence in the global monetary system will be shaken if the real contents of Fort Knox are confirmed and are not as claimed, so don’t expect an actual audit to occur.
- Physical gold securely stored outside the banking system has none of the above mentioned problems. The same is true for silver.

I repeat: Gold is Good. Sovereign Debt is Bad.

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Meet QT; QE's Evil Twin

Peter Schiff

There is a growing sense across the financial spectrum that the world is about to turn some type of economic page. Unfortunately no one in the mainstream is too sure what the last chapter was about, and fewer still have any clue as to what the next chapter will bring.

There is some agreement however, that the age of ever easing monetary policy in the U.S. will be ending at the same time that the Chinese economy (that had powered the commodity and emerging market booms) will be finally running out of gas. While I believe this theory gets both scenarios wrong (the Fed will not be tightening and China will not be falling off the economic map), there is a growing concern that the new chapter will introduce a new character into the economic drama.

As introduced by researchers at Deutsche Bank, meet "Quantitative Tightening," the pesky, problematic, and much less disciplined kid brother of "Quantitative Easing." Now that QE is ready to move out...QT is prepared to take over.

For much of the past generation foreign central banks, led by China, have accumulated vast quantities of foreign reserves. In August of last year the amount topped out at more than \$12 trillion, an increase of five times over levels seen just 10 years earlier. During that time central banks added on average \$824 billion in reserves per year.

The vast majority of these reserves have been accumulated by China, Japan, Saudi Arabia, and the emerging market economies in Asia (*Shrinking Currency Reserves Threaten Emerging Asia, Bloomberg Business, 4/6/15*). It is widely accepted, although hard to quantify, that approximately two-thirds of these reserves are held in U.S. dollar denominated instruments (*COFER, Washington DC: Intl. Monetary Fund, 1/3/13*), the most common being U.S. Treasury debt.

Continued on page 6

Failure To Launch

Continued from page 2

In addition, the Atlanta Fed's "GDPNow" statistics, which attempt to offer a real time glimpse at economic conditions, gets similarly short shrift in the media. That number currently stands at just .9% annualized growth. However, consensus on Wall Street for Q3 GDP remains at 2.4%.

Those forecasts should have been slashed months ago. But they have not. Based on the reports that I am seeing, I believe that there is a good chance that the barely positive growth rate that the Atlanta Fed is seeing for Q3, could turn negative.

After all, jobs reports have been revised down in six of the last eight months (BLS). What makes economists think that this trend will suddenly reverse? It is, therefore, more likely that the awful employment picture for September will even get worse. A negative GDP print in the third and fourth quarters of this year, which would qualify as a recession, is a possibility that Wall Street has not even considered, let alone prepared.

If weakening conditions prevent the Fed from pulling the rate hike trigger by December, can we really expect it to do it in the election year of 2016? With the economy already on thin ice, a rising rate environment may likely push the economy into recession if it somehow isn't already there.

This will play directly into the hands of the Republicans who will be able to hammer the outgoing Obama Administration's economic legacy, thereby handing the election to the GOP.

Does anyone really expect the left-leaning Federal Reserve led by Janet Yellen to do that? Given that, we may not see a rate increase until 2017, even if conditions improve, which is a dubious proposition.

Predictably, Goldman Sachs' chief economist Jan Hatzius came out with a statement today predicting the first move may not come until 2017.

Continued on page 8

One By One The Central Banks Are Losing Control

Continued from page 2

In short, a new player is in the global currency war. And it represents the second largest economy in the world. Having said that, we want you to take note of a few lessons from this situation:

- 1) There are in fact problems that are too big for Central Banks to manage.
- 2) Central Banks are in fact individual entities. True, they try to coordinate their moves, but when push comes to shove, it will be each Central Bank for itself. This trend will be increasing going forward.
- 3) Central Banks have no problem lying about the significance of a situation right up until they shock the market (both the SNB and the PBOC's moves were suddenly announced).

Of these, #1 is the most important. Since the mid-'80s, the general consensus has been that there is no problem too great that Central Banks cannot fix it. This has been the case because most crisis that have occurred during that period were either isolated to a particular market (Asian Crisis, Latin American Crisis, Russian Ruble Crisis, etc.) or a particular asset class (Tech Bubble, Housing Bubble, etc.).

This situation has resulted in less and less volatility in the financial system, combined with increased risk taking on the part of investors. As a result, the necessary deleveraging has never been permitted to occur and the financial system has become increasingly leveraged (meaning more and more debt).

You can see this in the below chart revealing total credit market instruments in the US (this only includes investment grade bonds, junk bonds, and commercial paper). The deleveraging of the 2008 crisis which nearly took down the entire financial system was a mere blip in a mountain of debt (and this doesn't even include US sovereign debt, emerging market debt, derivatives, etc.).

Today, when you include global debt issuance, we are facing a debt super crisis, the likes of which has never existed before: \$100 trillion in global bonds, with an additional \$555 trillion in derivatives.

Central Banks, by printing money, began a war of competitive devaluation in 2008. This worked fine when they were coordinating their moves to prop the system up from 2009-2011. We even had some coordinated efforts by the Fed and the ECB to push the markets higher in 2012 in order to benefit President Obama's re-election campaign.

However, 2012 marked the high water mark for Central Bank intervention without political repercussions. From that point onward, all Central Bank began to lose their political capital rapidly.

1. In Japan, the Bank of Japan's policies are demolishing the Middle Class. The number of Japanese living on welfare just hit a record and real earnings and household spending have been in a free fall since the middle of 2014.
2. In Europe, the ECB's President Mario Draghi has admitted in parliament that he was concerned about a "deflationary death spiral" and admitted that QE was the last tool left. **Half of the ECB's Board is against his direction.**
3. In the US, the Fed is now being targeted by Congress. Legislation has been introduced to audit the Fed AND force it to abide by the Taylor Rule.
4. In China, deflation is spiraling out of control with a stock market crash, housing bubble bursting, and economic downturn that is more severe than most realize.

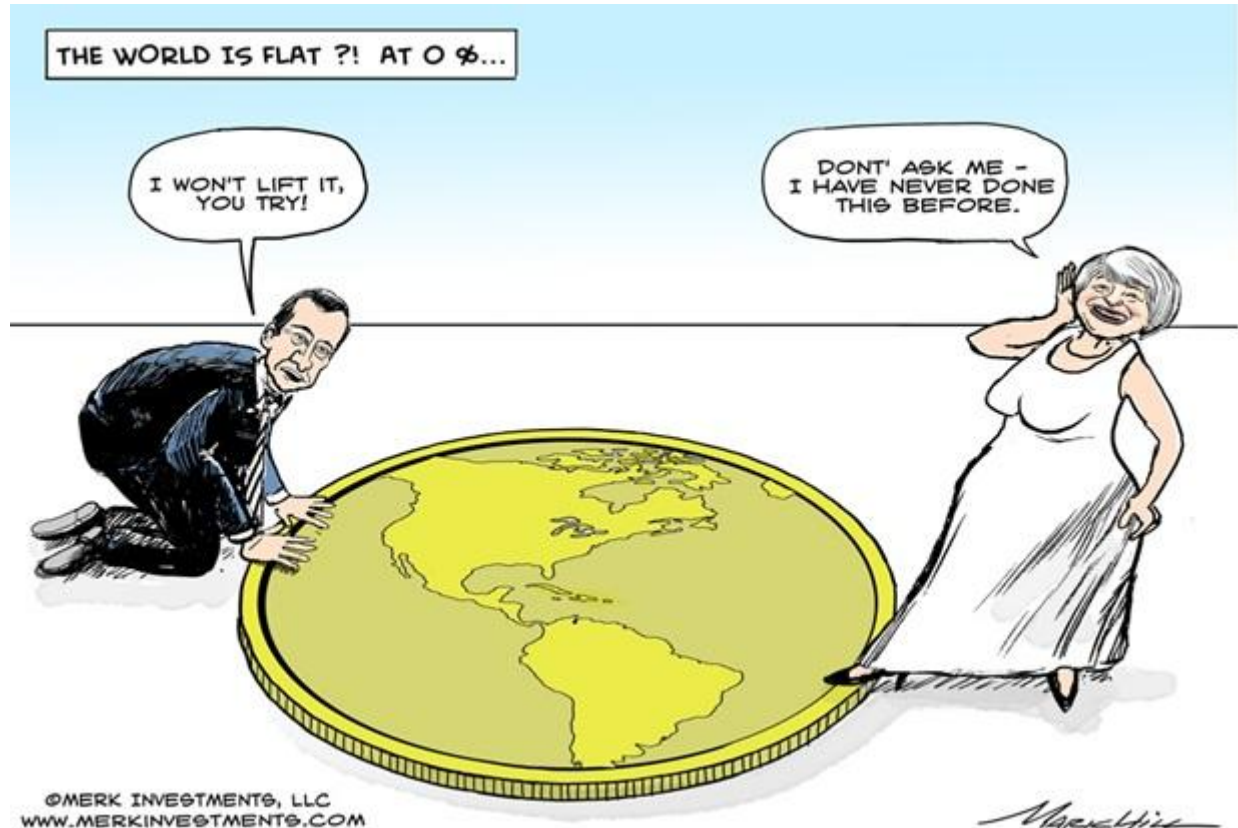
The significance of these developments cannot be overstated. Central Banks will be increasingly acting against one another going forward. **There will more surprises and more volatility across the board.** Eventually it will culminate in a Crash that will make 2008 look like a picnic.

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All Bad At 0%?

Axel Merk

We call on central banks to abolish their zero interest rate policy (ZIRP) framework before more harm is done. In our assessment, ZIRP is bad for all stakeholders and may even lead to war.



ZIRP: Bad for Business?

At first blush, it may appear great for business to have access to cheap financing. But what may be good for any one business is not necessarily good for the economy. When interest rates are artificially depressed, it can subsidize struggling enterprises that might otherwise be driven out of business. As a result, productive capital can be locked into zombie enterprises. If ailing businesses were allowed to fail, those laid off would need to look for new jobs at firms that have a better chance of succeeding. As such, the core tenant of capitalism: creative destruction, may be undermined through ZIRP. In our assessment, the result is that an economy grows at substantially below its potential.

ZIRP: Bad for Investors?

Investors may have enjoyed the rush of rising asset prices as a result of ZIRP. However, this may well have been a Faustian bargain as the Federal Reserve (Fed) and other central banks have masked, but not eliminated, the risks that come with investing. Complacency has been rampant, as asset prices rose on the backdrop of low volatility. When volatility is low (more broadly speaking, we refer to "compressed risk premia"), rational investors tend to allocate more money to historically risky assets. While that may be exactly what central banks want - at least for the real economy - investors may bail out when volatility spikes, as they realize they didn't sign up for this ("I didn't know the markets were risky!").

We believe that until early August this year, investors generally "bought the dips" out of concern of missing out on rallies. Now, they may be "selling the rallies" as they scramble to preserve their paper gains. This process is driven by the Fed's desire to pursue an "exit." For more details on this, please see our recent Merk Insight "[Lowdown on Rate Hikes](#)."

But it's not just bad because asset prices might crumble again after their meteoric rise; it's bad because, in our analysis, ZIRP has driven fundamental analysts to the sideline. For anecdotal evidence, look no further than the decision by Barron's Magazine to kick Fred Hickey (who may well be one of the best analysts of our era) out of the Barron's Roundtable. Instead, money looks to be flocking towards investment strategies based on momentum investing, a strategy that works until it doesn't. Again, ZIRP gives capitalism a bad name because we feel it disrupts efficient capital allocation.

Continued on page 6

Meet QT; QE's Evil Twin

Continued from page 3

Initially this "Great Accumulation" (as it became known) was undertaken as a means to protect emerging economies from the types of shocks that they experienced during the 1997-98 Asian Currency Crisis, in which emerging market central banks lacked the ammunition to support their free falling currencies through market intervention.

It was hoped that large stockpiles of reserves would allow these banks to buy sufficient amounts of their own currencies on the open market, thereby stemming any steep falls.

The accumulation was also used as a primary means for EM central banks to manage their exchange rates and prevent unwanted appreciation against the dollar while the Greenback was being depreciated through the Federal Reserve's QE and zero interest rate policies.

The steady accumulation of Treasury debt provided tremendous benefits to the U.S. Treasury, which had needed to issue trillions of dollars in debt as a result of exploding government deficits that occurred in the years following the Financial Crisis of 2008. Without this buying, which kept active bids under U.S.

Treasuries and long-term interest rates in the U.S. could have been much higher, which would have made the road to recovery much steeper. In addition, absent the accumulation, the declines in the dollar in 2009 and 2010 could have been much more severe, which would have put significant upward pressure on U.S. consumer prices.

But in 2015 the tide started to slowly ebb. By March of 2015 global reserves had declined by about \$400 billion in just about 8 months, according to data compiled by Bloomberg. Analysts at Citi estimate that global FX reserves have been depleted at an average pace of \$59 billion a month in the past year or so, and closer to \$100 billion per month over the last few months (*Brace for QT...as China leads FX reserves purge, Reuters, 8/28/15*).

Continued on page 7

All Bad At 0%?

Continued from page 5

ZIRP: Bad for Main Street?

Excessively low interest rates are also bad for Main Street. In our analysis, excessively low interest rates are a key driver of the growing wealth gap in the U.S. and abroad. Hedge funds and sophisticated investors seemed to thrive as they engaged in highly levered bets; at the other end of the spectrum are everyday people that may not get any interest on their savings, but are lured into taking out loans they may not be able to afford. We believe ever more people are vulnerable to "fall through the cracks" as they encounter financial shocks, such as the loss of a job or medical expenses; hardship may be exacerbated because people had been incentivized to load up on debt even before they encountered a financial emergency. Again, we believe ZIRP gives capitalism a bad name, although ZIRP has nothing to do with capitalism.

Low interest rates may not even be good for home buyers: it may sound attractive to have low financing cost, but the public appears to slowly wake up to the fact that when rates are low, prices are higher: be that the prices of college tuition or homes. It's all great to have high home prices when you are a home owner, but it's not so great when you are trying to buy your first home.

ZIRP: Bad for Price Stability?

While we believe inflation may ultimately be a problem if interest rates are kept too low for too long, ZIRP may temporarily suppress inflation. While this may sound counter-intuitive, it is precisely because of the aforementioned capital misallocation ZIRP may be fostering: when inefficient businesses are being subsidized, as we believe ZIRP does, inflation dynamics may not follow classical rulebooks. That's because an economy with inefficient capital resource allocation experiences shifts in supply of goods and services that may not match demand leading to what may appear to be erratic price shifts. The most notable example may be commodity prices, where the extreme price moves in recent years are a symptom that not all is right.

ZIRP: Bad for Politics?

In our assessment, Congress has increasingly outsourced its duties to the Fed (the same applies to politicians and central bankers to many other parts of the world). The Fed now ought to look after inflation, employment, and financial stability. The Fed, in our humble opinion, is not only ill suited to tackle most of these, but invites political backlash as they step on fiscal turf. Let me explain: monetary policy focuses on the amount of credit available in the economy; in contrast, fiscal policy - through tax and regulatory policy - focuses on how this credit gets allocated. If the Fed now allocates money to a specific sector of the economy, say, the mortgage market by buying Mortgage Backed Securities (MBS), they meddle in politics. Calls to "audit the Fed" are likely a direct result of the Fed having overstepped their authority, increasingly blurring the lines between the Fed and Congress.

More importantly, the U.S., just like Europe and Japan, face important challenges that in our opinion can neither be outsourced, nor solved by central banks in general or ZIRP in particular.

ZIRP: Bad for Peace?

In 2008 and subsequent years, you likely heard the phrase, "Central banks can provide liquidity, but not solvency." In essence, it means central banks can buy time. But what happens when central banks buy a lot of time and underlying problems are not fixed? In our assessment, it means that the public gets antsy, gets upset. When problems persist for many years the public demands new solutions. But because monetary policy is too abstract of an issue for most, they look for solutions elsewhere, providing fertile ground for populist politicians. Here are just a few prominent political figures that have thrived due to public frustration with the status quo: Presidential candidate Donald Trump; Senator and Presidential candidate Bernie Sanders; Greek Prime Minister Tsipras; Ukrainian Prime Minister Yatsenyuk; Japanese Prime Minister Abe; and most recently the new leader of UK's Labor Party Jeremy Corbyn.

And what do just about all politicians - not just the ones mentioned above - have in common? They rarely ever blame themselves; instead, they seem to blame the wealthy, minorities or foreigners for any problems.

We believe the key problem many countries have is debt. I allege that if countries had their fiscal house in order, they would rarely see the rise of populist politicians. While there are exceptions to this simplified view, Ukraine may not be one of them: would Ukraine be in the situation it is in today if the country were able to balance its books?

Continued on page 7

Meet QT; QE's Evil Twin

Continued from page 6

Some think that these declines stem largely by actions of emerging economies whose currencies have been falling rapidly against the U.S. dollar that had been lifted by the belief that a tightening cycle by the Fed was a near term inevitability.

It was speculated that China led the reversal, dumping more than \$140 billion in Treasuries in just three months (through front transactions made through a Belgian intermediary - solving the so-called "Belgian Mystery") (*China Dumps Record \$143 Billion in US Treasuries in Three Months via Belgium, Zero Hedge, 7/17/15*). The steep decline in the Chinese stock market has also sparked a flight of assets out of the Chinese economy. China has used FX sales as a means to stabilize its currency in the wake of this capital flight.

The steep fall in the price of oil in late 2014 and 2015 also has led to diminished appetite for Treasuries by oil producing nations like Saudi Arabia, which no longer needed to recycle excess profits into dollars to prevent their currencies from rising on the back of strong oil. The same holds true for nations like Russia, Brazil, Norway and Australia, whose currencies had previously benefited from the rising prices of commodities.

Analysts at Deutsche Bank see this liquidation trend holding for quite some time. However, new categories of buyers to replace these central bank sellers are unlikely to emerge. This changing dynamic between buyers and sellers will tend to lower bond prices, and increase bond yields (which move in the opposite direction as price). Citi estimates that every \$500 billion in Emerging Markets FX drawdowns will result in 108 basis points of upward pressure placed on the yields of 10-year U.S.

Treasuries (It's Official: China Confirms It Has Begun Liquidating Treasuries, Warns Washington, Zero Hedge, 8/27/15). This means that if just China were to dump its \$1.1 trillion in Treasury holdings, U.S. interest rates would be about 2% higher. Such an increase in rates would present the U.S. economy and U.S. Treasury with the most daunting headwinds that they have seen in years.

The Federal Reserve sets overnight interest rates through its much-watched Fed Funds rate (that has been kept at zero since 2008). But to control rates on the "long end of the curve" requires the Fed to purchase long-dated debt on the open market, a process known as Quantitative Easing. The buying helps push up bond prices and push down yields. It follows then that a process of large scale selling, by foreign central banks, or other large holders of bonds, should be known as Quantitative Tightening.

Potentially making matters much worse, Janet Yellen has indicated the Fed's desire to allow its current hoard of Treasuries to mature without rolling them over. The intention is to shrink the Fed's \$4.5 trillion dollar balance sheet back to its pre-crisis level of about \$1 trillion. That means, in addition to finding buyers for all those Treasuries being dumped on the market by foreign central banks, the Treasury may also have to find buyers for \$3.5 trillion in Treasuries that the Fed intends on not rolling over.

The Fed has stated that it hopes to effectuate the drawdown by the end of the decade, which translates into about \$700 billion in bonds per year. That's just under \$60 billion per month (or slightly smaller than the \$85 billion per month that the Fed had been buying through QE). Given the enormity of central bank selling, and the incredibly low yields offered on U.S. Treasuries, I cannot imagine any private investor willing to step in front of that freight train.

So even as the Fed apparently is preparing to raise rates on the short end of the curve, forces beyond its control will be pushing rates up on the long end of the curve. This will seriously undermine the health of the U.S. economy even while many signs already point to near recession level weakness.

Just this week, data was released that showed U.S. factory orders decreasing 14.7% year-over-year, which is the ninth month in a row that orders have declined year-over-year. Historically, this type of result has only occurred either during a recession, or in the lead up to a recession.

The August jobs report issued today, which was supposed to be the most important such report in years, as it would be the final indication as to whether the Fed would finally move in September, provided no relief for the Fed's quandaries.

Continued on page 8

All Bad At 0%?

Continued from page 6

Central banks are clearly not appointing populist politicians, but we allege ZIRP provides a key ingredient that allows such politicians to rise and thrive. ZIRP has allowed governments to carry what we believe are excessive debt burdens though ZIRPs cousin quantitative easing ("QE"). QE is essentially government debt monetization in our view. Take the Fed's U.S. treasury buying QE program. Those Treasuries (or new Treasuries that the Fed rolls into) might be held indefinitely by the Fed (despite claims of balance sheet normalization) - meaning that US Government will never pay the principle, and the U.S. Government effectively pays zero interest on that debt because the profits of the Fed flow back to the US Treasury. ZIRP allows governments to engage on spending sprees, such as a boost of military spending Prime Minister Abe might pursue.

The Great Depression ultimately ended in World War II. I'm not suggesting that the policies of any one politician currently in office or running for office will lead to World War III. However, I am rather concerned that the longer we continue on the current path, the more political instability will be fostered that could ultimately lead to a major international conflict.

How to get out of this mess

It's about time we embrace what we have been lobbying for since the onset of the financial crisis: the best short-term policy is a good long-term policy. We have to realize that when faced with a credit bust, there will be losers, and that printing money cannot change that. In that spirit, we must not be afraid of normalizing policy in fear of causing an economic setback. When rates rise, businesses that should have failed long ago are likely to fail. Rather than merely rising rates, though, policy makers must provide a long-term vision of the principles that guides their long-term policy. In our humble opinion, "data dependency" is an inadequate principle, if it is one at all.

The Fed needs to have the guts to tell Congress that it is not their role to fix their problems. It requires guts because they must be willing to accept a recession in making their point.

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Meet QT; QE's Evil Twin

Continued from page 7

While the headline rate fell to a near generational low of 5.1%, the actual hiring figures came in at just 173,000 jobs, which was well below even the low end of the consensus forecast.

Private sector hiring led the weakness, manufacturing jobs declined, and the labor participation rate remained at the lowest level since 1976. So even while the Fed is indicating that it is still on track for a rate hike, all the conditions that Janet Yellen wanted to see confirmed before an increase are not materializing. This is a recipe for more uncertainty, even while certainty increases overseas that U.S. Treasuries are troubled long term investments.

The arrival of Quantitative Tightening will provide years' worth of monetary headwinds. Of course the only tool that the Fed will be able to use to combat international QT will be a fresh dose of domestic QE. That means the Fed will not only have to shelve its plan to allow its balance sheet to run down (a plan I never thought remotely feasible from the moment it was announced), but to launch QE4, and watch its balance sheet swell towards \$10 trillion. Of course, these monetary crosscurrents should finally be enough to capsize the U.S. dollar.

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Peter Schiff
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<http://www.europac.com/>

The Outstanding Public Debt

National Debt:

18,152,381,314,829.02

The estimated population of the United States is 321,535,954

US citizen's share of this debt is \$56,455.21

The National Debt has continued to increase an average of \$1.89 billion per day

Business, Government, Financial and Unfunded Liabilities Debt exceeds \$100 Trillion

Failure To Launch

Continued from page 4

Look for many other influential economists to follow suit. My view is that it is far more likely that we will see a fresh round of Quantitative Easing before we see a rate hike. As far as I know, however, I am still one of the only economists making this "outrageous" forecast.

The biggest practical implications of all this is that the commodity and foreign currency markets, which have been so thoroughly decimated by expectations of imminent rate hikes in the U.S., should reverse course. In the past, the dollar has generally risen on the anticipation of rate hikes and has sold off when the Fed actually delivered on those expectations.

This is the classic "buy the rumor, sell the fact" trade. But what will happen when the Fed fails to deliver? Then all we have is false rumor and no fact. In such a scenario, reversals in the "bid up" dollar and in "beaten down" commodities like gold, silver, copper, and oil, could be dramatic.

This could be especially true when you consider all the global economic problems that would be solved by a weaker dollar. Already we are seeing the markets drifting in that direction. Today silver hit a three-month high, and other commodities are finally getting up off the mat. It's been a long time coming, and I expect that it's a pattern that will take hold for a long time to come.

When the jobs report was released last Friday, markets reacted initially with a sharp 200-point sell off. For a while, traders seemed to forget that it's not the economy that has driven the markets but Fed stimulus. They thought bad news was actually bad news. But that "perverse" sentiment didn't last. Once it became clearer (to some) that rate hikes this year were less likely, the markets reversed course and completed a 450-point reversal to the upside. The Fed has created a phony "bad is good economy" and we are not about to snap out of it any time soon.

I expect that once the threat of rate hikes is finally and officially taken off the table, the Wall Street rally will continue. But those gains will be attenuated by a weaker dollar and depressed earnings by domestically focused companies. In that case, it may be better to search for stocks outside the dollar and for the potential benefit of rising share prices and a rising currency. Given how far those assets have been beaten down (see my [commentary of July 6th](#)), the opportunities may be worthwhile.

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